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IN THE

Supreme Court of the United States

October Term, 1964.

No. 354

THOMAS C. BALLAGH and VERA REED BALLAGH,
Petitioners,

v.

THE UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS.

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v.

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS.

Thomas C. Ballagh and Vera Reed Ballagh pray that a Writ of Certiorari issue to review the judgment of the United States Court of Claims, entered in the above-entitled case on May 15, 1964.

CITATION TO OPINION BELOW.

The opinion of the Court of Claims printed in Appendix B hereto, *infra* p. 15, is reported in 331 Fed. 2d 874.

JURISDICTION.

The judgment of the United States Court of Claims was entered on May 15, 1964: p. 34, *infra*. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1255(1).

QUESTION PRESENTED.

Is a taxpayer whose primary purpose is to obtain retirement income, who considers tax deductibility of interest in calculating the cost and would not have taken the contract otherwise, entitled to an allowance of an income tax deduction for interest paid an insurance company on a loan for prepayment of premiums on an annuity contract where he did not borrow back any of the cash surrender value during the seven years before the dispute, and thereby obtained a substantial annuity?

STATUTES INVOLVED.

Statutory provisions are cited and quoted in Appendix A, *infra*, pp. 13-14.

STATEMENT.

Petition was filed in the United States Court of Claims requesting refund of income tax paid after final disallowance of deductions (for payment of interest on loan to prepay annuity where there was no borrowing back).

Petitioners in 1947, having the primary purpose of obtaining retirement income, and considering the deductibility of interest payments in the total cost (Findings of Fact 12 and 14), bought an annuity contract, paid $10,000, the first premium, borrowed $236,000 from a bank to prepay forty years' premiums, executed a loan agreement for the $236,000 to the Standard Life, which repaid the bank (Finding of Fact 5). Petitioners paid Standard Life interest on the loan, and in 1947 deducted it on their income tax return. After an audit when the contract and loan agreement was examined, that deduction was allowed. A similar deduction was allowed in 1952 (Finding of Fact 24).

Petitioners paid $9,769.97 interest in 1953 and $19,584.84 interest in 1954, and deducted these payments on their 1953 and 1954 returns (Finding of Fact 1). These deductions were finally disallowed and the petitioners paid

the resulting additional assessments with interest in the amount of $25,755.48 on December 23, 1959, and brought this action in the Court of Claims for its recovery (Finding of Fact 2).

The transaction is similar to that ruled on in *Knetsch v. U. S.*, 364 U. S. 361, with this important difference, that from its inception in 1947 Mr. Ballagh never borrowed back the cash surrender value. Knetsch bought his contract December 11, 1953 and thereafter as he paid his interest, he borrowed back all of the increase in cash surrender value, which returned to his pocket most of the money he had paid as interest, and which destroyed any chance of the contract's producing an annuity (which annuity depended on the increase of the cash surrender value).

The Supreme Court in denying Knetsch a deduction of the interest, called it a

> ". . . fiction, because each year Knetsch's annual borrowings kept the net cash value, on which annuity or insurance payments would depend, at the relative pittance of $1,000.00. . . . It is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction . . ."

Mr. Ballagh, however, never borrowed back at any time from 1947 to 1954, his interest payments were out of pocket payments, and the cash surrender value increased each year (by the payment of premiums from the premium deposit fund established by the original loan) so that when in December 1956 he cancelled his loan and took a paid-up contract, he had an annuity which at sixty-five will pay him $621.88 a month, or both petitioners and the survivor $552.29 a month.

The Supreme Court said in the *Knetsch* case:

> "There may well be single premium annuity arrangements with non-tax substance which create an

'indebtedness' for the purpose of Sec. 23(b) of the 1939 Code and Section 163(a) of the 1954 Code. But this one is a sham."

We submit that Mr. Ballagh's case is such a case "with non-tax substance".

There have been numerous decisions since the *Knetsch* case in which it has been applied or distinguished.

In every one cited at the trial and argument in this case (and every one the writer has found), where the deduction of interest was disallowed, there was "borrowing back" of substantially all of the cash surrender value or in the securities loan cases, there were no actual securities to be held as a pledge, but merely "wash" sales. In other words, "what was done" established the fact of "sham".

On the other hand, the deduction of interest was allowed in the one case of an annuity contract loan where there was no borrowing back.

Loughran v. Commissioner, 19 T. C. M. 1193, and in numerous cases where the pledged securities were actually in existence.

Doyle v. Commissioner, 286 Fed. 2d 654;
Maysteel Products v. Commissioner, 287 Fed. 2d 429;
Herbert Humphreys v. Commissioner, 301 Fed. 2d 33;
Ludens v. USA, 196 Fed. Supp. 525;
Hanover Bank Ex. v. Commissioner, 369 U. S. 672;
Stanton v. Commissioner, 34 T. C. 1.

We submit that this decision of the Court of Claims (1) is contrary to the spirit and language of the *Knetsch* case, (2) conflicts with the Laws of Congress as they existed when the contract and the interest payments were made and makes the Acts of 1954 and 1964 retroactive in violation of its restriction to the future, and (3) although by its findings of fact establishes that the transaction was legitimate and had non-tax substance, yet ends with a conclusion of law that is contrary to such findings of fact.

REASONS FOR GRANTING THE WRIT.

I. The Decision Is Contrary to the Spirit and Language of the Supreme Court's Decision in *Knetsch* v. U. S., 364 U. S. 361.

In *Knetsch*, "what was done", the borrowing back not only restored most of the interest money to Knetsch immediately, but it eliminated the non-tax purpose of establishing an annuity, by taking out all of the cash surrender value on which the annuity depended.

Mr. Bailagh from 1947 to 1954 never borrowed back at all (and was out of pocket his interest), but allowed the cash surrender value to increase so that it would and did provide him with a substantial annuity.

It is clear that in 1947 and under every Revenue Act from 1934 to 1954 interest on loans to create or maintain *annuities* WAS DEDUCTIBLE. The reasons for this may be the same under which Congress now permits exclusions for retirement deposits. The result is really postponement of taxation to a time when brackets may be lower. This is not theoretical in Mr. Bailagh's case, because his contract and loan agreement were reviewed in 1947 and the deduction of interest was allowed. We hasten to state that this is not an argument for estoppel, but it shows that practice followed the Acts of Congress.

When, therefore, the Act of 1954 changed the law for future contracts and the Internal Revenue Commissioner sought to deny interest deductions on annuity loans, he could do so only where, as in *Knetsch*, he could show that the *only* purpose of the transaction was the tax deduction. The law is clear that if there was non-tax substance as well as the tax deduction, the taxpayer could not be denied the deduction.

Knetsch stands for the proposition that where there is no non-tax substance (as where the form is merely a sham) and the only purpose to be served is tax saving, the deduction should be disallowed.

The spirit and language of *Knetsch* are contrary to the decision here, which in spite of a finding that the primary purpose was to obtain an annuity, the seven year conduct of non-borrowing which supported that purpose, and the end result of producing an annuity, ends with a conclusion of law denying the deduction.

As we have noticed above, the decisions since the *Knetsch* case (except this *Ballagh* case) have interpreted the *Knetsch* decision to apply only where there is no non-tax substance.

The opinion of the Court of Claims lists three points:

1. The opinion states that taxpayer's motive (although legitimate) is not controlling.

Whereas here taxpayer's primary purpose was to obtain an annuity at the least cost, and what he did actually accomplished this—there cannot logically be a finding that the transaction was a sham. On the contrary it was real, it had a real purpose, it had non-tax substance and "what was done" was consistent with and accomplished that non-tax purpose.

The *Knetsch* case held that regardless of the way the transaction started out (regardless of the motive in that sense) "what was done" i.e. the borrowing back, destroyed the possibility of carrying out any motive or purpose to get an annuity, and in that sense the existence of a purpose could not stand against the fact of what was done, which frustrated such purpose.

In the *Knetsch* case, with the possibility of an annuity destroyed, the Court said there was nothing of non-tax substance left and the only purpose was the tax deduction.

Here Mr. Ballagh's conduct supported and did not destroy the non-tax substance but the result like the purpose and "what was done" was an annuity.

2. The opinion having findings of fact that the primary purpose was to obtain an annuity and that the non-borrowing increased cash value which produced an annuity, says that it was no sham to buy the annuity, but it was a sham to borrow on it.

This has no basis in logic.

(a) There could be no interest hence no deduction unless there was a borrowing.

It makes meaningless the Acts of Congress from 1934 to 1954, which by eliminating annuities, permitted deduction of interest. In effect, it makes the Acts of 1954 and 1964 retroactive in spite of their restriction to the future.

It is also tantamount to denying the statement of the *Knetsch* case

> "There may well be single premium annuity arrangements with non-tax substance which create an 'indebtedness' for the purpose of Sec. 23(b) of the 1939 Code and Section 163(a) of the 1954 Code."

(b) There is implicit in this part of the opinion, the argument that the petitioners had no right to consider the deductibility of interest payments at all.

This is contrary to law.

Taxpayers have the right to decide whether to mortgage, even though they have cash, whether to lease rather than buy, even though they have the cash, because measuring the choices the deductibility of interest makes the mortgage or lease cheaper than buying outright with cash.

The Court says that Mr. Ballagh could have bought his annuity and paid annual premiums annually, and that the borrowing feature with the tax deductibility of interest could have been left out. That statement would apply to any loan. The Findings of Fact 12 and 14 show that Mr. Ballagh would not have taken the contract without these features. This was a permissible decision.

It is contrary to the law and to common sense, that the making of a loan constitutes a sham merely because it

will reduce cost (or postpone taxes) by making interest payments deductible.

3. The opinion distinguishes the *Loughran* decision (*supra*) where deduction of interest was allowed, on the ground that the loan was left with the bank instead of being transferred to the insurance company.

In effect this says that if Mr. Ballagh had left his loan with the bank that originally had it, his payments of interest would have been deductible. We submit that whether the bank held the loan or the insurance company held it could make no legal difference.

We are all familiar with borrowing on a life insurance policy. It can be done by having the company grant the loan or by assigning the policy to a bank which makes the loan. In either case, the interest is deductible (except that where the interest is not paid in cash, but is merely added to the loan by the insurance company, it is not deductible).

The Courts have held that whether a loan is with the insurance company or a stranger makes no difference. *Est. Pat E. Hooks*, 22 T. C. 502.

The Revenue Act of 1964, P. L. 88, 272 likewise makes no difference between loans "from insurer or others".

We submit that none of these points in the opinion answers the Findings of Fact 12 and 14 which establish a non-tax purpose, carried to a successful completion by "what was done" (Finding of Fact 13) at all times consistent with such non-tax purpose and non-tax result, and that the Opinion is in conflict with the *Knetsch* case and the Acts of Congress.

II. The Decision Attempts to Change the Statutory Law to Make Retroactive the Acts of 1954 and 1964, Which Specifically Restrict Their Effect to the Future, and Nullifies the Effect of the Act of 1934, Which by Omitting Annuities When Reenacting the 1932 Act, Permitted Deduction of Interest on Annuity Loans.

By the Act of June 6, 1932, 47 Stat. 179, Sec. 23(b) excluded as a permitted deduction

"All interest paid . . . (2) on indebtedness incurred or continued in connection with the purchase or carrying of an . . . annuity."

However, this was promptly deleted by the Revenue Act of May 10, 1934, Stat. 688, which changed Section 22(b)(2) by omitting the word annuity. During all of the period from 1934 to 1954, the Acts of Congress omitted the prohibition against deducting payments of interest on annuity loans.

We submit that this is an area in which Congress acted and it had a right if it said so to encourage retirement savings by postponement of tax (for Mr. Ballagh will eventually pay tax although presumably in lower brackets).

In the Revenue Act of 1964, P. L. 88, p. 272, Congress spoke again

"Sec. 215 Interest on Loans Incurred to Purchase Certain Insurance and Annuity Contracts

"(a) Disallowance of Interest Deduction—Section 264(a) (relating to certain amounts paid in connection with insurance contracts) is amended—

"(1) by inserting after paragraph (2) the following new paragraph:

"(3) Except as provided in subsection (c), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise."

"(2) by adding at the end thereof the following new sentence:

"Paragraph (3) shall apply only in respect of contracts purchased after August 6, 1963."

This later Act again emphasizes the restriction to the future, and emphasizes that the thing that is wrong about such transactions is the "systematic . . . borrowing of . . . increases in the cash value of such contract (either from insurer or otherwise)".

We submit that this Act showed that Congress in enacting this Act in effect approved Mr. Ballagh's claim for deduction.

The answer to all this is that Mr. Ballagh had a valid transaction. Under his partner's identical contract, identically treated, claim for identical deduction of identical payments in the identical years was approved. Only in those cases where borrowing back vitiated the contract has it been held otherwise. And when the Congress finally spelled out the basis for refusing the deduction, it spelled out the borrowing back restriction.

This *Ballagh* decision is specifically contrary to what Congress has said.

The reasoning of this opinion would simply make the Act of 1954, which is specifically limited to future contracts, retroactive or would reenact the 1932 Act skipping the 1934 and intervening Acts.

We submit that in the *Knetsch* case, the Supreme Court **did not do this.**

In effect, it did not deny the right to deduct interest on an annuity loan where there was non-tax substance in the transaction.

In fact, the Supreme Court held that to deny it, the Commissioner had to establish and the Court had to find that the transaction had no non-tax substance and was a "sham". In the absence of this (and we submit it was absent under Findings of Fact 12, 13, 14 in the *Ballagh* case) the deduction of interest was allowable.

The Act of 1964 follows what I have said about the meaning of the *Knetsch* case.

III. The Decision Is Contrary to the Findings of Fact in the *Ballagh* Case Which Establishes as a Matter of Fact That the Transaction Was Not "Sham".

"12. . . . He had determined to buy an annuity contract that would provide him a satisfactory income at age 65, and in entering into the contract . . . he took into account the total cost of the annuity contract, including the deductibility of interest paid under the loan agreement.

"13. Mr. Ballagh has never borrowed against the increasing cash value of his insurance contract with Standard Life, although he had a right to do so under the terms of the policy . . .

"14. The evidence as a whole shows that Mr. Ballagh's primary purpose in entering into the transactions with Standard Life was to provide a satisfactory retirement income at age 65, but the deductibility of the interest payments from his income tax was considered by him as an important factor in the total cost of providing such retirement income, and he would not have purchased the policy, nor entered into the other transactions connected therewith had he known that the interest payments would not be deductible."

"9. . . . The insurance contract is still in force, and if Mr. Ballagh elects to begin the receipt of annuities at age 65, the contract will pay him an annuity of $621.88 per month, or will pay to petitioners and survivor an annuity of $552.29 per month".

These findings establish non-tax substance in the beginning, in "what was done" and in the result.

We incorporate here by reference the discussion of the three points, which the Opinion proposes against this. We submit that none of them overcomes the said Findings of Fact.

The Court should grant this petition for certiorari to make clear the limits of the *Knetsch* decision, to affirm the supremacy of the Acts of Congress limiting the Acts of 1954 and 1964 under its own restrictions to the future and to avoid the inconsistency of a decision where the Findings of Fact entitle plaintiff to recover but are voided by clearly inconsistent conclusions of law.

CONCLUSION.

For the foregoing reasons, this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

WALTER B. GIBBONS,
FRANK J. EUSTACE, JR.,
Counsel for Petitioners.

APPENDIX A.

Act of June 6, 1932, 47 Stat. 179, Sec. 23(b)

"In computing net income there shall be allowed as deductions:

"(b) Interest—All interest paid or accrued within the taxable year on indebtedness, except (1) on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title, or (2) on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity."

Revenue Act of May 10, 1934, 48 Stat. 688, Sec. 23(b)

"In computing net income there shall be allowed as deductions:

"(b) Interest—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title."

Act of August 16, 1954, 68 Stat. 77 Sec. 264

"(a) General Rule—No deduction shall be allowed for . . .

"(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium . . . annuity contract . . .

"Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

"(b) Contracts treated as Single Premium Contracts—For purposes of sub-section (a)(2) a contract shall be treated as a single premium contract—

"(1) if substantially all the premiums on the contract are paid within a period of four years from the date on which the contract is purchased.

"(2) if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract."

The Revenue Act of February 26, 1964, P. L. 88—272

"Sec. 215. Interest on Loans Incurred to Purchase Certain Insurance and Annuity Contracts

"(a) Disallowance of Interest Deduction. Section 164(a) (relating to certain amounts paid in connection with insurance contracts) is amended—

"(1) by inserting after paragraph (2) the following new paragraph:

"(3) Except as provided in subsection (c) any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise)."

APPENDIX B.

(331 F. 2d 874)

IN THE UNITED STATES COURT OF CLAIMS

No. 393-60

(Decided May 15, 1964)

THOMAS C. BALLAGH AND VERA REED BALLAGH

v.

THE UNITED STATES

Frank J. Eustace, Jr., for plaintiffs.

David D. Rosenstein, with whom was *Assistant Attorney General Louis F. Oberdorfer*, for defendant. *Edward S. Smith*, *Lyle M. Turner*, and *Philip R. Miller* were on the brief.

Before JONES, *Chief Judge*, WHITAKER, LARAMORE, DURFEE, and DAVIS, *Judges*.

OPINION

JONES, *Chief Judge*, delivered the opinion of the court:

Plaintiffs, husband and wife who filed joint tax returns for the periods here pertinent, brought this suit to recover $25,792.02 as alleged overpayment of Federal income tax and interest for the calendar years 1953 and 1954. In their returns, plaintiffs claimed deductions in the amounts of $9,769.97 for the year 1953 and $19,584.84 for the year 1954 as interest payments. The Internal Revenue Service dis-

allowed these deductions and determined a deficiency for each year. Plaintiffs paid the deficiencies and brought this action for refund. The sole issue for our determination is whether these payments were "interest paid * * * on indebtedness" within the meaning of § 23(b) of the Internal Revenue Code of 1939 and § 163(a) of the Internal Revenue Code of 1954.[1] Thomas C. Ballagh will hereinafter be referred to as plaintiff.

On December 20, 1947, plaintiff and Standard Life Insurance Company of Indiana (hereinafter referred to as Standard Life) entered into an insurance contract which provided for a life annuity of $6,813.18 per month to be paid to plaintiff commencing December 20, 1988, in exchange for 41 annual premiums of $10,000 each. On the day of the contract, plaintiff paid the initial year's premium of $10,000 to put the policy into effect. According to the contract plaintiff had the right to prepay any amount of the premiums which would be due in the future, and the amount so prepaid would bear interest at a minimum rate of 2½ percent per year or at such higher rate as Standard Life declared. In fact, plaintiff was allowed a compound discount of 2.85 percent on prepaid premiums.

At the time of the contract, and with the compound discount rate of 2.85 percent, $236,856 was the amount which was required to prepay all future premiums. On the same day plaintiff entered into the contract, the Corn Exchange National Bank and Trust Company of Philadelphia (hereinafter referred to as the Bank) issued a cashier's check in the amount of $236,856, payable to plaintiff's order, in exchange for plaintiff's demand note for the same amount, secured by the insurance policy referred to above. It was a condition of the loan that plaintiff would immediately endorse the cashier's check over to Standard Life. He did

1. Plaintiffs being calendar-year taxpayers, the 1954 Code is applicable to their 1954 tax return by virtue of § 7851(a)(1)(A). However, as the Supreme Court has noted in *Knetsch v. United States*, 364 U. S. 361, 362, footnote 1, "[t]he relevant words of the two sections are the same * * *."

so, and the Bank credited the $236,856 to the account of Standard Life. On December 26, 1947, Standard Life acknowledged receipt of $236,856 as a deposit by plaintiff in full payment of 40 annual premiums on the insurance contract from December 19, 1948 to December 19, 1988. This $236,856 was placed in a "premium deposit account" which was increased by the compound interest of 2.85 percent per year, and decreased by the amount of annual premiums as they became due. The total value of the contract, then, was the sum of the amount in the premium deposit account plus the tabular cash value of the policy.

On December 27, 1947, plaintiff and Standard Life executed a "Loan Agreement," under the provisions of which plaintiff was to pay Standard Life $236,856, with interest at the rate of 4 percent per annum on the portion secured by the amount remaining in the premium deposit account and at the rate of 6 percent per annum on the portion secured by the tabular cash value of the policy. By the terms of the loan agreement, the debt would be payable and enforceable solely out of the security which was the insurance contract plaintiff had with Standard Life. In return, Standard Life was to pay, and did pay on December 27, 1947, $236,856 to the Bank. Thereafter, the Bank cancelled plaintiff's demand note, and plaintiff paid the Bank $184 as one week's interest on the $236,856.

Additional terms of the loan agreement entitled plaintiff to prepay interest at a compound discount of 2 percent per year, but he could not prepay more than 10 percent of the principal amount of the loan in any one year. On December 27, 1947, plaintiff made out five separate checks to Standard Life in the total amount of $45,568.04. Each of these checks contained a statement that by endorsement thereon the check was accepted by Standard Life in prepayment of one year's interest on the loan. Thereafter, in December of each of the years 1952, 1953, and 1954, plaintiff paid the sums of $9,693.04, $9,769.97, and $19,584.84, respectively, to Standard Life. These were prepayments

of interest due under the loan agreement. The "interest payments" plus the initial premium of $10,000, or an aggregate of $94,615.89, were the only sums paid by plaintiff to Standard Life. The amounts paid in 1953 and 1954 are the subject of this suit.

At the end of the above series of transactions, plaintiff had an insurance contract with Standard Life, and all of the premiums which would have been due thereon had been prepaid by a deposit of $236,856 in a premium deposit account. This $236,856 was borrowed from Standard Life and plaintiff was obligated to repay Standard Life the $236,856, plus interest, but this obligation was enforceable solely out of the cash or loan value of the insurance contract. Standard Life was paying plaintiff interest of 2.85 percent on the $236,856 plaintiff had deposited in the premium deposit account, while plaintiff was paying Standard Life interest of 4 to 6 percent on the $236,856 he borrowed from Standard Life. The role of the Bank was that of a middleman: There was an agreement between the general agent of Standard Life and the Bank, whereby the Bank agreed to facilitate transactions involving such insurance plans, and it was understood by all parties that the loan would ultimately be carried by Standard Life rather than by the Bank.

On December 20, 1956, at the request of plaintiff, the loan agreement was cancelled and the policy under the insurance contract was converted to paid-up for its net cash value of $66,388.89. This paid-up policy is still in force.

It was found by the trial commissioner, and not disputed by the parties, that had plaintiff not engaged in the transaction involving the loan of $236,856, and had he paid Standard Life all the payments he actually made as prepayments of premiums rather then as interest under the loan agreement, the net cash value of the insurance contract would have been $98,359.86, on December 20, 1956. Thus, Standard Life's "fee"[2] for its arrangement of the loan

2. *Knetsch v. United States*, 364 U. S. 361, 366 (1960).

transaction was $31,970.97, the difference between $98,359.86 and $66,388.89. Although plaintiff ended up with a policy having less cash value, he also benefited from the loan transaction. Plaintiff realized a tax saving of $39,427 as a result of deducting "loan interest" of $45,568.04 from his gross income for 1947, plus a further tax saving of $7,558 as a result of deducting the $9,693.04 "loan interest" from his gross income for 1952. Therefore, plaintiff had a net profit, to date, for his participation in the loan transaction of about $15,000, the difference between the total tax savings realized and Standard Life's "fee" for arranging the loan transaction.

The Government does not concede that any of the payments plaintiff made to Standard Life were properly deductible as "interest" payments. However, the statute of limitations now bars additional assessments for the years prior to 1953. We are concerned, therefore, only with the "interest payments" for the years 1953 and 1954.

The facts of the present case are very similar to those of *Knetsch v. United States*, 364 U. S. 361 (1960). In *Knetsch*, the taxpayer bought deferred annuity savings bonds in 1953 from an insurance company totaling $4,000,000 in face value, and bearing interest at 2½ percent compounded annually. The purchase price was $4,004,000. Knetsch gave the company his check for $4,000, and signed $4,000,000 of nonrecourse annuity loan notes for the balance. The notes bore 3½ percent interest and were secured by the annuity bonds. The interest was payable in advance, and Knetsch paid the first year's $140,000 interest at the time of the purchase. Under the terms of the bonds, their cash or loan value at the end of the first contract year was to be $4,100,000. The contract terms permitted Knetsch to borrow the excess of this value above his indebtedness without waiting until the end of the contract year. Five days after the purchase Knetsch borrowed from the company $99,000 of the $100,000 excess over his $4,000,000 indebtedness, for which he gave his

notes bearing 3½ percent interest. This interest was also payable in advance and on the same day he prepaid the first year's interest of $3,465. Thus, at the end of the first contract year, Knetsch had bonds with a cash value of $4,100,000 and an indebtedness of $4,099,000. In his tax return for 1953, Knetsch deducted the sum of the two interest payments, or $143,465, as "interest" under § 23(b) of the 1939 Code.

The above described process, except for the initial purchase, was repeated in 1954 at the beginning of the second contract year. Again Knetsch sought to deduct the two interest payments, under § 163(a) of the 1954 Code, which was then applicable.

The Commissioner of Internal Revenue disallowed the deductions and determined a deficiency for each year. Knetsch paid the deficiencies and sued in the District Court for refund. The District Court's judgment for the United States was eventually affirmed by the Supreme Court. The Supreme Court examined "what was done" in *Knetsch* and found that:

> Plainly, therefore, Knetsch's transaction with the insurance company did "not appreciably affect his beneficial interest except to reduce his tax . . . ." *Gilbert v. Commissioner*, 248 F. 2d 399, 411 (dissenting opinion). For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly "lent" back was in reality only the rebate of a substantial part of the so-called "interest" payments. The $91,570 difference retained by the company was its fee for providing the facade of "loans" whereby the petitioners sought to reduce their 1953 and 1954 taxes in the total sum of $233,297.68.[3]

We believe that the Supreme Court's holding in *Knetsch* is completely dispositive of the present case. Plain-

3. *Id.* at 366.

tiff's *loan* transaction with Standard Life did "not appreciably affect his beneficial interest except to reduce his tax * * *." To paraphrase the District Court's conclusion of law in *Knetsch*, quoted in the Supreme Court's opinion,[4] we find that "while in form the payments to Standard Life were compensation for the use or forbearance of money, they were not in substance. As a payment of interest, the transaction was a sham."

Plaintiff attempts to distinguish the *Knetsch* case from the present situation by contending that his transaction with Standard Life was a valid, as distinguished from a sham, transaction. As support for this contention he points to various findings by the trial commissioner to the effect that plaintiff's primary purpose in entering into the transaction with Standard Life was to provide for a retirement income, but that the deductibility of the interest payments was considered in computing the total cost of the plan; and that plaintiff never borrowed against the increasing cash value of his policy, as did Knetsch, which borrowing would have destroyed the purpose of providing retirement income. We think that plaintiff's evidence does not support his contention.

In the first place, the taxpayer's motive, in cases such as the present one, is not controlling. The often quoted language of the Supreme Court in *Gregory v. Helvering*, 293 U. S. 465, 469, is appropriate here:

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. . . . But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.

This point was specifically reaffirmed by that Court in *Knetsch*, in putting aside a finding by the District Court on Knetsch's motive.[5]

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4. *Id.* at 365.
5. *Id.* at 365.

In the second place, plaintiff is wide of the mark in supposing that his primary purpose of providing retirement income can make valid what would otherwise be a sham. For the transaction which we find to be a sham is not the initial insurance contract but the prepayment of all of the premiums and the loan agreement. We do not question that plaintiff's motive in buying the policy was a legitimate one. However, the subsequent prepayment of all premiums by borrowing from the insurance company itself was not necessary in so providing retirement income, and we find that such loan transaction did "not appreciably affect his beneficial interest except to reduce his tax." Since the payments made were part of the loan transaction which we have found to be a sham, we may disregard the payments for the purposes of the tax statute. *Gilbert v. Commissioner*, 248 F. 2d 399, 411 (dissenting opinion); *Gregory v. Helvering*, 293 U. S. 465; *Higgins v. Smith*, 308 U. S. 473, 477; *Griffiths v. Commissioner*, 308 U. S. 355; *Bazley v. Commissioner*, 331 U. S. 737.

Finally, we think the fact that plaintiff never borrowed against the increasing cash value of his policy is not pertinent in considering the deductibility of these payments. To hold otherwise would be to ignore the teachings of the Supreme Court in the *Knetsch* case. The Court there concluded that what Knetsch was ostensibly "lent" back was in reality only the *rebate* of a substantial part of the so-called "interest" payments. We hold that it makes no difference in these cases whether the taxpayer receives the rebate in the form of a loan or whether he receives it in the form of cash value in the policy.

There remain for our consideration the two cases cited by plaintiff as supporting his contention. *Loughran v. Commissioner*, 19 T. C. M. 1193 (decided October 10, 1960); *Stanton v. Commissioner*, 34 T. C. 1 (decided April 7, 1960). Both of these cases are distinguishable from *Knetsch* on the facts. In *Loughran*, and in *Stanton*, there were actual bank loans with interest paid to the banks. As the Tax Court

has pointed out in *Stanton*,[6] in the *Knetsch* line of cases the interest on the bank loans was not in controversy. Since the present dispute does not involve the $184 plaintiff paid to the Bank, *Loughran* and *Stanton* are not apposite.

Plaintiffs are not entitled to recover and their petition is dismissed.

FINDINGS OF FACT

The court, having considered the evidence, the report of Trial Commissioner Wilson Cowen, and the briefs and argument of counsel, makes findings of fact as follows:

1. The plaintiffs, husband and wife, filed joint individual income tax returns with the District Director of Internal Revenue in Philadelphia, Pennsylvania, for the calendar years 1953 and 1954. In such returns they claimed deductions in the amounts of $9,769.97 for the year 1953 and $19,584.84 for the year 1954 as interest payments made to the Standard Life Insurance Company of Indiana during those years.

2. Upon audit and examination, the Internal Revenue Service on October 2, 1958, disallowed the claimed deductions. As a result thereof income tax deficiencies in the amount of $6,933.30 and $12,844.32 were assessed against the plaintiffs for the years 1953 and 1954, respectively. On December 23, 1959, plaintiffs paid these deficiencies, plus assessed interest thereon, or a total of $9,299.08 and $16,492.94 for the years 1953 and 1954, respectively, to the District Director of Internal Revenue at Philadelphia Pennsylvania. On January 25, 1960, the plaintiffs filed claims for refund of the amounts thus paid, and by certified mail dated September 29, 1960, the claims for refund were disallowed. On October 11, 1960, interest of $36.54 was refunded to the plaintiffs.

3. Since 1933 Mr. Ballagh has been the partner of Grant Thrall. They were and are in the export business

6. 34 T. C. at 10.

performing services as manufacturers' representatives in nearly all of the countries of the free world. Due to changing conditions in foreign countries and other factors, the income from this business was subject to wide fluctuation.

4. The year 1947 was a good year in the partnership business, the partnership earning a good deal more money than during the preceding year. Mr. Ballagh and Mr. Thrall wished to provide some plan which would provide a regular income upon their retirement. Edwin D. Parker, an insurance broker who had sold them other insurance, presented to them a plan in December 1947 for an annuity contract with the Standard Life Insurance Company of Indiana, hereinafter referred to as Standard Life.

5. In the last 2 weeks of the year 1947 Mr. Ballagh entered into a series of transactions with Standard Life and the Corn Exchange National Bank and Trust Company of Philadelphia, hereinafter referred to as the Corn Exchange Bank. These transactions were part of the comprehensive plan which was outlined to Mr. Ballagh by Mr Parker, the insurance broker. These transactions were as follows:

(A) On December 20, 1947, Mr. Ballagh and Standard Life entered into an insurance contract which provided for a life annuity of $6,813.18 per month to be paid to him commencing on December 20, 1988. The stated consideration for the contract was an annual premium of $10,000 for 41 years. Under the terms of the policy the cash value thereof increased from year to year as the annual premiums were paid. The contract also contained a provision entitled "Premium Deposit Fund", under which Mr. Ballagh had the right to prepay any amount he chose on premiums thereafter due. It further provided that any amounts so prepaid would bear interest at a minimum rate of $2\frac{1}{2}$ percent per year or at such higher rate as the company declared. Mr. Ballagh was allowed a compound discount of 2.85 percent on prepaid premiums.

(B) On December 20, 1947, Mr. Ballagh deposited with Mr. Parker, the insurance broker, a check for $10,000 in payment of the initial year's premium on the policy, and this payment put the policy in force.

(C) On December 20, 1947, Mr. Ballagh executed a demand note in the amount of $236,856, payable to the Corn Exchange Bank. This sum was equal to the amount required to prepay all premiums which would in the future become due on the policy. In exchange for his note, the Corn Exchange Bank issued a cashier's check in the amount of $236,856, payable to the order of Mr. Ballagh. Collateral security for this loan was the insurance policy referred to in (A) above.

(D) A condition of the loan was that Mr. Ballagh would immediately endorse the cashier's check over to Standard Life. He did so, and the Corn Exchange Bank credited the $236,856 to the account of Standard Life.

(E) On December 26, 1947, Standard Life acknowledged receipt of $236,856 as a deposit by Mr. Ballagh in full payment of 40 annual premiums on the insurance contract from December 19, 1948 to December 19, 1988.

(F) On December 27, 1947, Mr. Ballagh and Standard Life executed a document entitled "Loan Agreement", under the provisions of which he was obligated to pay Standard Life $236,856, with interest at the rate of 4 percent per annum on the portion secured by the premiums deposited and at the rate of 6 percent per annum on the portion secured by the tabular cash value of the policy. As security for payment Mr. Ballagh assigned the insurance contract and all premiums deposited thereunder to Standard Life.

(G) On or about December 27, 1947, Standard Life paid $236,856 to the Corn Exchange Bank, whereupon the demand note given by Mr. Ballagh to the bank was can-

celled. No other money or property was received by him from Standard Life in return for his promise under the loan agreement to pay Standard Life the $236,856, plus interest thereon.

(H) On or about December 29, 1947, Mr. Ballagh's cancelled note was returned to him, and he paid the Corn Exchange Bank $184, representing one week's interest on the $236,856.

6. Mr. Ballagh was entitled to prepay interest due under the loan agreement at a compound discount of 2 percent per annum. On December 27, 1947, he executed five separate checks payable to Standard Life in the total amount of $45,568.04. Each check contained a statement that by endorsement thereon the check was accepted in prepayment of one year's interest on the loan to Standard Life.

On December 10, 1952, December 10, 1953, and December 3, 1954, plaintiffs paid the sums of $9,693.04, $9,769.97, and $19,584.84, respectively, to Standard Life. Each of the checks contained a statement that the check was issued as a prepayment of interest due under the loan agreement. The amounts paid in 1953 and 1954 are the subject of this suit.

7. The amounts shown in the preceding finding, plus the initial premium of $10,000, or an aggregate of $94,615.89, were the only sums paid by plaintiffs to Standard Life.

8. On December 20, 1956, the following endorsement was placed on the insurance contract:

> On the request of Thomas C. Ballagh, the annuitant, this policy is converted to paid-up for its net cash value of $66,388.89 as at December 20, 1956, as provided herein.

Concurrently, the loan agreement attached to the insurance contract was cancelled.

9. At the time the insurance contract was converted the net cash value of $66,388.89 represented the cash value of the policy as of December 20, 1956, plus the surrender value of the premium deposit account on the same date, less the $236,856 owing to Standard Life under the loan agreement. The insurance contract is still in force, and if Mr. Ballagh elects to begin the receipt of annuities at age 65, the contract will pay him an annuity of $621.88 per month, or will pay to plaintiffs and survivor an annuity of $552.29 per month.

10. At the time he entered into the transactions involved herein Mr. Ballagh was 44 years old and was concerned about retirement income because of the fluctuating nature of his business. As a self-employed person he was at that time eligible for social security.

11. The plan presented by Mr. Parker, the insurance broker, was outlined to Mr. Ballagh and to Mr. Thrall at the same time and both entered into an identical series of transactions. Mr. Parker had known the partners for a number of years and had previously discussed the matter of providing a retirement plan for them. In the course of the discussions regarding the Standard Life plan, Mr. Parker showed Mr. Ballagh copies of letters that had been sent by the Deputy Commissioner of Internal Revenue to other persons who were buying or had bought similar insurance contracts. The letters stated that interest paid on loans obtained for the purpose of paying premiums in advance on such insurance annuity contracts would be deductible under the provisions of section 23(b) of the Internal Revenue Code of 1939.

12. At the conclusion of the transactions entered into with the Corn Exchange Bank and Standard Life, it was

Mr. Ballagh's understanding that he had an annuity contract with Standard Life on which premiums had been prepaid for 40 years and that on the security of the contract, he had received a loan on which he would be obligated to pay interest. He also understood that he had a right to prepay interest on the loan at a discount and that in any future year selected, he could pay off the loan and receive a paid-up annuity. On the basis of the information he received, he believed that the interest payments made to Standard Life under the loan agreement would be deductible on his Federal income tax returns. Before he entered into the insurance contract with Standard Life, he obtained some figures from an actuary showing the net cost of the policy without considering the deductibility of interest payments on a loan secured by the policy. He had determined to buy an annuity contract that would provide him a satisfactory income at age 65, and in entering into the contract with Standard Life and the other transactions described herein, he took into account the total cost of the annuity contract, including the deductibility of interest paid under the loan agreement.

13. Mr. Ballagh has never borrowed against the increasing cash value of his insurance contract with Standard Life, although he had a right to do so under the terms of the policy. Had he borrowed and not repaid part of the cash value, the annuities payable under the policy would have been reduced.

14. The evidence as a whole shows that Mr. Ballagh's primary purpose in entering into the transactions with Standard Life was to provide for a satisfactory retirement income at age 65, but the deductibility of the interest payments from his income tax was considered by him as an important factor in the total cost of providing such retire-

ment income, and he would not have purchased the policy, nor entered into the other transactions connected therewith had he known that the interest payments would not be deductible.

15. The following table illustrates the amount that would have been paid to Mr. Ballagh under the insurance contract with Standard Life upon surrender of the policy at the end of each policy year over a period of 9 years, on the basis of the total payments, including premiums and prepaid interest, which he made to Standard Life:

(1)	(2)	(3)	(4)	(5)	(6)
Contract year.	*Amounts paid by taxpayers to Standard Life*	*Net cash value of contract at end of each year* [2]	*Prepaid interest payable on surrender at end of year*	*Total payable on surrender ((3) plus (4))*	*Yearly increase. (*) *Decrease in total payable on surrender*
1	[1] $55,568.04	$ 6,751.13	$37,001.60	$43,752.73	$43,762.73
2		15,608.93	28,077.92	43,686.85	(65.80)
3		22,371.48	18,975.17	41,346.65	(2,340.20)
4		29,236.06	9,618.24	38,854.30	(2,492.35)
5		36,399.88		36,399.88	(2,454.42)
6	9,693.64	43,560.07		43,560.07	7,160.19
7	9,769.97	50,913.68		50,913.68	7,353.61
8	19,584.84	58,557.66	9,930.46	68,488.12	17,574.44
9		66,388.87		66,388.89	(2,099.23)

[1] Includes the $10,000 initial premium paid and interest prepayment of $45,568.04.

[2] These figures represent the sum of the premium deposit account plus the tabular cash value of the contract less the amount of loan outstanding against the contract.

16. As stated in a preceding finding, the insurance contract with Standard Life included a provision entitled "Premium Deposit Fund", under which he was entitled to prepay future premiums. Any amount so prepaid would bear interest at a minimum rate of 2½ percent per year. The following table illustrates what the results would have been had Mr. Ballagh entered into the insurance contract when he did, had not engaged in the transactions involving the loan of $236,856, and had paid Standard Life all the

payments he actuallly made as prepayments of premiums rather than as interest under the loan agreement:

(1)	(2)	(3)	(4)	(5)	(6)
Contract year	*Amounts paid by taxpayers to Standard Life*	*Premium deposit account at end of each year*	*Tabular cash value at end of each year*	*Total payable on surrender at end of each year ((3) plus (4))*	*Yearly increase in total payable on surrender*
1	$55,568.04	$46,707.24		$46,707.24	$46,707.24
2		37,624.92	$12,000	49,824.92	3,117.68
3		28,315.54	22,400	50,715.54	890.62
4		18,773.43	32,800	51,573.43	857.89
5		8,992.77	43,600	52,592.77	1,019.34
6	9,693.04	8,902.96	54,500	63,402.96	10,810.19
7	9,769.97	8,889.75	65,700	74,589.75	11,186.79
8	19,584.84	18,936.45	77,300	96,236.45	21,646.70
9		9,159.86	89,200	98,359.86	2,123.71

17. Had the plan illustrated in the foregoing table been followed, Mr. Ballagh would have received a paid-up annuity in the amount of $98,359.86 at the end of the ninth year that the policy was in force in return for payments aggregating $94,615. As shown in defendant's exhibit 8, Mr. Ballagh calculated that the total value of the plan he actually followed was $113,373, consisting of a paid-up annuity as of December 20, 1956, of $66,388.89, plus a tax saving of $39,427 as a result of paying $45,568.04 as loan interest in 1947, plus a further tax saving of $7,558 as a result of paying $9,693.04 as loan interest in 1952. He calculated the net cost of the plan as $94,799, representing $94,615 paid to Standard Life and $184 paid to the Corn Exchange Bank. His conclusion was that he had a net profit or an increased value over cost of $18,584.

18. As shown in finding 5(D) Mr. Ballagh did not have free use of the $236,856, which he borrowed from the Corn Exchange Bank on December 20, 1947, since it was a condition of the loan that he would promptly endorse the cashier's check over to Standard Life. Although he had done business with the bank for a number of years prior to the loan in question, he had not previously borrowed from the

bank. The balance in his account on December 20, 1947, in the bank was not sufficient to cover a demand loan of $236,856. There was an agreement between the general agent of Standard Life and the Corn Exchange Bank, whereby the bank agreed to facilitate transactions involving such insurance plans, and it was understood by all parties that the loan would ultimately be carried by Standard Life rather than by the bank.

19. The loan agreement, which is in evidence as exhibit 6 to the stipulation and is made a part hereof, provided:

> The entire debt evidenced by this note or any balance due thereon shall be payable, and enforceable by the payee, solely out of the security hereinafter mentioned.

As security for the loan agreement Mr. Ballagh assigned the insurance contract and all premiums deposited thereunder to Standard Life.

The loan agreement also provided that if the interest on the principal was not paid when due, such interest would be added to the principal and if and when the principal exceeded the cash or loan value of the security, the security would be applied in full payment of the debt and the loan agreement would be returned to Mr. Ballagh marked "Paid in Full".

20. The loan agreement also contained a provision limiting the amount which could be prepaid on the loan in any 1 year to not more than 10 percent of the principal amount of the loan. This provision is unusual in insurance loan contracts, which generally provide that a loan may be repaid at any time before default in payment of the premiums. Mr. Ballagh did not repay any part of the principal due under the loan agreement prior to the time the insurance policy was converted to a paid up annuity on December 20, 1956, when the loan agreement was cancelled.

21. Under the arrangement Mr. Ballagh entered into with Standard Life, he received a discount of 2.85 percent interest on prepaid premiums held in the premium deposit fund, but under the terms of the loan agreement he was required to pay Standard Life interest on the loan at a rate which would increase from 4 percent to 6 percent. Each year Standard Life made a profit on the difference between the discount he was allowed on prepaid premiums and the interest he was required to pay on the outstanding loan. No risk of loss was incurred by Standard Life, since his obligation to pay was secured by the premium deposit fund and the cash value of the policy.

22. The tabular cash value of an annual premium policy increases only through interest on accumulated net premiums and the additional premiums which the insurance company receives each year. Net premium is the gross premium, less whatever portion thereof that is deducted by the insurance company to pay for agent's commissions, home office administrative expense, and other expenses. Although the only out-of-pocket premium paid by Mr. Ballagh was the initial annual premium of $10,000 paid in 1947, the cash value of his insurance contract increased from year to year due to the payment of annual premiums out of the premium deposit fund.

23. On November 28, 1956, Standard Life sent plaintiffs a letter advising them of the joint life and survivor annuities available under the insurance contract. The letter stated in part as follows:

> We have given the figures both on the assumption that you will leave the policy unchanged and pay only on the loan interest as it becomes due, and also th[at] you convert the policy to paid-up on December 20, 1956 and make no futher [sic] payments on it.

The figures submitted were as follows:

JOINT LIFE AND SURVIVOR ANNUITY GUARANTEED 10 YEARS AVAILABLE DEC. 20
Male born Aug. 11, 1903. Female born Nov. 16, 1903

Year	*Cash value*	*Monthly payments* Level	*Monthly payments* Reducing to two-thirds
	If no change and loan interest paid		
1956	$66,388.89	$272.88	$303.40
1957	74,404.16	311.01	345.98
1958	82,700.17	352.30	392.00
1959	91,273.52	395.21	440.85
1960	100,120.71	442.53	493.79
	If policy converted to paid-up Dec. 20, 1956		
1956	$66,388.89	$272.86	$303.40
1957	68,380.56	285.83	317.97
1958	70,431.98	300.04	333.85
1959	72,544.94	314.12	350.39
1960	74,721.29	330.27	368.38

The figures shown in the upper table under the column entitled "Cash Value" represent the sum of the tabular cash value of the policy and the cash surrender value of the premium deposit fund, less the $236,856 owed to Standard Life under the loan agreement. The figures for the years 1957-1960 in the lower table under the column entitled "Cash Value" represent in each instance the figure for the preceding year, plus interest accumulated thereon at 3 percent per annum.

24. Plaintiffs' income tax return for 1947, in which $45,568.04 paid to Standard Life under the loan agreement was claimed as an interest deduction, was audited and approved by the Internal Revenue Service. In plaintiffs' 1952 income tax return they also claimed a deduction for the $9,693.04 paid as interest to Standard Life under the loan agreement. Although the evidence does not show whether the 1952 return was audited by the Internal Revenue Service, no deficiencies were assessed against plaintiffs for that year.

Plaintiffs' income tax returns for 1953 and 1954 were audited and examined in 1958. However, if the examining agent of the Internal Revenue Service had audited the returns 6 or 8 months earlier, he would probably have allowed the payments made by plaintiffs to Standard Life as interest deductions. However, shortly before the audit, the Assistant Regional Commissioner issued a directive, stating in effect that the examining agents should disallow deductions claimed as interest payments on such insurance contracts.

25. The insurance broker who sold the Standard Life insurance contract to Mr. Ballagh sold an identical policy and plan to W. Stewart Emmons in 1951. The mechanics of the transactions Mr. Emmons entered into with Standard Life and the Corn Exchange Bank were the same as in Mr. Ballagh's transactions described in these findings. However, each year Mr. Emmons borrowed back from the increasing cash value of his policy the full amount that was permitted by the terms of the policy. As a result when his policy was surrendered or converted, he had an equity of only $1,000 therein.

CONCLUSION OF LAW

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that plaintiffs are not entitled to recover and the petition is dismissed.